United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

ORIGINAL

To Be Argued By
WILLIAM D. GREENE

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P/S

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

76-7125

GERALD LIPSKY, executor under the Will of WALDEN ROBERT CASSOTTO (a/k/a BOBBY DARIN) deceased,

Plaintiff-Appellant,

-against-

COMMONWEALTH UNITED CORPORATION (now known as IOTA INDUSTRIES, INC.); COMMONWEALTH UNITED MUSIC, INC.; THE HUDSON BAY MUSIC COMPANY (formerly known as ALLEY-STREET MUSIC VENTURE); ALLEY MUSIC CORPORATION; and STREET SONGS, INC.,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR DEFENDANTS-APPELLEES
IOTA INDUSTRIES, INC. AND
COMMONWEALTH UNITED MUSIC, INC.

BURNS, VAN KIRK, GREENE & KAFER
Attorneys for Defendants-Appellees
Iota Industries, Inc. and
Commonwealth United Music, Inc.
Office and Post Office Address
521 Fifth Avenue
New York, New York 10017
Telephone: (212) 972-0500

WILLIAM D. GREENE
JAMES P. CORCORAN
Of Counsel

Appeal Reproductions Inc., 217 Broadway, New York, N.Y. 10007
Tel: 233-6626

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES: **PAGE**

TABLE OF AUTHORITIES

CASES (cont'd):

TABLE OF AUTHORITIES

CASES (cont'd):

TABLE OF AUTHORITIES

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BRIEF FOR DEFENDANTS-APPELLEES IOTA INDUSTRIES, INC. and COMMONWEALTH UNITED MUSIC, INC.

PRELIMINARY STATEMENT

Plaintiff appeals from a final order and judgment dismissing its Second Amended Unified Complaint with prejudice and from a prior order to strike scandalous and prejudicial matter from plaintiff's Amended Unified Complaint, both entered by the United States District Court for the Southern Districtof New York, Hon. Frank H. McFadden sitting by assignment. The orders and judgment have not been officially reported.

STATEMENT OF ISSUES PRESENTED FOR REVIEW

1. Was it reversible error for the District Court to find that rescission is not an available remedy in this case (a) where the alleged breach of the Agreement was only incidental to the exchange of T. M. stock and other assets, and not the essence of the Agreement; (b) where plaintiff has alleged no breach of contract by the party receiving T. M.'s assets; (c) where T. M.'s assets have passed into the ownership and possession of third parties who are bona fide purchasers for value; (d) where it is impossible to restore all of the parties to the status quo existing at the time of the closing of the Agreement; (e) where plaintiff's decedent delayed for almost nine months after the alleged breach became known to him before seeking to rescind the Agreement?

2. Was it reversible error for the District Court to dismiss the Complaint where plaintiff failed to show how the alleged breach by Iota caused any injury to plaintiff's decedent?

3. Was it reversible error for the District Court to strike allegations from the Amended Unified Complaint where said allegations related to the position of the Securities and Exchange Commission regarding the attempted registration by Iota of various shares of stock, most of which were not even owned by plaintiff's decedent?

STATEMENT OF FACTS

On September 13, 1968, plaintiff's decedent, Walden Robert Cassotto, a/k/a Bobby Darin ("Darin"), entered into an Agreement with defendants Iota Industries, Inc. ("Iota") and Commonwealth United Music, Inc. ("CUM"), whereby Darin acquired 77,323 shares of Iota stock (pre 1 for 10 reverse split) in exchange for the transfer to CUM of all of the stock of T. M. Music, Inc. ("T. M."), a music publisher (App. 23, 47-8).

In Section 14 of the Agreement (App. 58), Iota promised that before the end of 1968 it would file a registration statement with the SEC covering the 77,323 shares Darin would receive thereunder. Plaintiff acknowledges in Paragraph 9 of the Complaint that on November 27, 1968, Iota's New York corporate attorneys caused a registration statement to be filed with the SEC covering Darin's Iota shares (App. 165). Such filing obviously was timely. No deficiency in the registration statement as then filed is alleged.

Section 14 of the Agreement further required Iota to use "its best efforts" to cause the registration statement "to become effective". That section set no date as to the target for Iota to achieve such effectiveness, but Section 4 of the Agreement states that Iota's obligation is to use best efforts to cause this filing "to become effective at the earliest practicable time." (App. 39)

Paragraph 9 of the Complaint (App. 166) conjoins these two provisions to charge conclusorily that Iota "failed to take reasonable steps, much less use its best efforts, to cause registration of Darin's stock to become effective at the earliest practicable time". However, the Complaint concedes that Iota made some efforts to cause the registration statement to become effective in that it made additional filings with the Commission, including two amendments to the registration statement, one on April 29, 1969 (¶11, App. 166) and another on June 27, 1969 (¶14, App. 167).

Other than the general conclusory allegation of breach, the only allegation of a failure by Iota to use best efforts is contained in Paragraph 11 of the Complaint (App. 166). There plaintiff claims that the April 29, 1969 amendment to the registration statement omitted to state the "nature and extent of Iota's relationship with Kleiner, Bell & Co." in connection with four securities transactions during 1968, and further omitted to state that Iota was obligated by an agreement dated March 18, 1969 to pay a premium price for 86,000 shares of Perfect Film & Chemical Corp. stock.

The Complaint does not allege any deficiency in the second amendment filed June 27, 1969. Thus, it appears that plaintiff bases his whole claim for rescission on the charge that Iota breached its best efforts commitment by omitting to state facts as to Kleiner Bell and Perfect Film in the amendment dated April 29, 1969.

The stock of Iota (which was then known as Commonwealth United Corporation) was listed and traded on the American Stock Exchange until July 22, 1969 when Iota requested that trading be suspended. On August 1, 1969, the SEC suspended over-the-counter trading in Iota securities. On or about December 23, 1969, such trading in Iota common stock was resumed. The closing quotation for Iota common stock on the American Stock Exchange on September 13, 1968 was 18. As of August 20, 1970, just seven days before the commencement of this suit, the over-the-counter price was approximately $.50 bid, $.75 asked (App. 164, 165).

This action was instituted on August 27, 1970 in the United States District Court for the Central District of California and was later transferred to the Southern District of New York pursuant to an order of the Judicial Panel on Multidistrict Litigation dated October 28, 1970 (App. 63). This action was transferred as a tag-along case to sixteen class and derivative suits then pending in the Southern District against Iota and/or the Seeburg Corporation, then an Iota subsidiary (Docket No. M-19-95). The sixteen suits were all consolidated into two class actions, *Land* and *Fried*, and have since been settled. The actions involved issues or law and fact similar to the instant suit.

Plaintiff, in his Second Amended Unified Complaint ("Complaint"), demands rescission for an alleged breach by

Iota of a covenant in the Agreement to use its "best efforts" to cause a registration statement covering Darin's shares under the Securities Act of 1933 to become ffective. If rescission is ordered, plaintiff further asks for conveyance to him of all assets owned by T. M. when the Agreement was closed, plus an accounting for profits accrued thereon since closing, or $2,000,000 in lieu thereof. To effectuate such relief, Hudson Bay Music Company, Alley Music Corporation and Street Songs, Inc. ("Hudson Bay defendants") are sued as transferees of at least some of those assets.

ARGUMENT

POINT I

RESCISSION IS NOT AN AVAILABLE REMEDY FOR THE ALLEGED BREACH OF CONTRACT SINCE THE LANGUAGE OF THE AGREEMENT SHOWS THAT IOTA'S PROMISE TO USE BEST EFFORTS TO REGISTER DARIN'S STOCK WAS ONLY INCIDENTAL TO THE EXCHANGE OF STOCK AND NOT THE ESSENCE OF THE AGREEMENT.

The allegations of the Complaint fail to support the demand for rescission. It is axiomatic that the remedy of rescission for breach of contract is permitted only for a "breach going to the root of the contract". *Callanan v. Keeseville, Ausable Chasm and Lake Champlain Ry. Co.*, 199 N.Y. 268, 284 (1910).

The rule was well stated in *Nolan v. Williamson Music, Inc.*, 300 F.Supp. 1311, 1317 (S.D.N.Y. 1969), aff'd 499 F.2d 1394 (2d Cir. 1974):

> "It is accepted law that not every breach of a contract will justify rescission. Rather, rescission can be permitted only when the complaining party has suffered breaches of so material and substantial a nature that they affect the very essence of the contract and serve to defeat the object of the parties. (Citing cases)
>
> "Cases which have considered the problem of rescission in situations analogous to the one presented by the case at bar have granted rescission only after finding the equivalent of a total failure in the performance of the contract."

In *Nolan*, plaintiff had sought rescission against defendants to whom it had sold its rights in a song. It alleged that the first defendant had failed to pay 74% of the royalties due plaintiff, had assigned its rights to a second defendant, and failed to permit inspection of corporate records as required by the Agreement. The court denied rescission since the breaches alleged were not so substantial as to amount to a total failure of consideration.

In the action at bar, it is clear from the Agreement that the essence of the contract was the transfer to CUM of T. M. stock in exchange for the transfer to Darin of Iota stock. Iota's subsequent obligation was to file a registration statement regarding Darin's stock and to exercise "best efforts" to effectuate registration. Iota never agreed that it was responsible for achieving the effectiveness of any registration statement. Thus, it was evident to all of the parties that even should Iota perform every covenant in the Agreement to the letter, registration might still never become effective. Obviously then, the essence of the Agreement could not be the registration of Darin's shares since there was never any certainty of that result. If registration were, in fact, the essence of the Agreement, the Agreement could simply have said so, and given Darin the right to rescind upon failure of registration by a date certain, but this is not what the Agreement provides.

The essential point which plaintiff cannot escape is that the sale of stock to Darin was not on condition that the stock was, or would be, registered. Since "best efforts" was not a guarantee of registration, the failure of said registration cannot be said to be of so substantial a nature as to result in a total failure in the performance of the contract. Plaintiff repeatedly alleges in his Complaint a material and substantial breach of the Agreement (Br. 2, 3, 15-16, 18, 33) but that avails him nothing unless the allegation is supported by the terms of the Agreement itself. The Agreement speaks for itself, and does not lend itself to the unique interpretation being offered by plaintiff.

There are numerous cases in the State of New York dealing with the issue of contract rescission, and the requirement that the alleged breach be a fundamental one. In *O'Herron v. Southern Tier Stores, Inc.*, 9 A.D.2d 568, 189 N.Y.S.2d 323 (3rd Dept. 1959), debentures to which plaintiff subscribed and paid for were not delivered for two years. Rescission was denied, the court holding that the delay was not material. In *Smith v. Johannsen*, 199 App. Div. 823, 192 N.Y.S. 478 (1st Dept. 1922), plaintiff alleged that he had received no profits pursuant to an agreement on which defendant had made $300,000. The court ruled that rescission was unwarranted simply because one party had failed to pay the other when the contract was otherwise fully executed. See

also *Tarleton Building Corp. v. Spider Staging Sales Co.*, 26 A.D.2d 809, 274 N.Y.S.2d 43 (1st Dept. 1966), where the court unanimously reversed a judgment for rescission; and *Fink v. Friedman*, 78 Misc.2d 429, 358 N.Y.S.2d 250 (Sup. Ct. Nassau Co. 1974). Both cases involved a breach by the contractor of a building contract, the courts holding that the breaches were not so substantial as to justify rescission.

The cases cited in plaintiff's brief do not support his unorthodox interpretation of the instant Agreement or plaintiff's demand for the extraordinary remedy of rescission. In *Lauer v. Raymond*, 190 App. Div. 319, 180 N.Y.S. 31 (1st Dept. 1920), plaintiffs bought five hundred shares of stock on condition that certain persons were not connected with the corporation. Plaintiffs were entitled to rescission therein because it was manifestly clear that plaintiffs would not have bought the stock except for defendant's misrepresentation. This is clearly distinguishable from the action at bar since Darin and the other parties to the contract never agreed to make the whole transaction contingent upon registration, and there was clearly no misrepresentation by Iota on that point.* For the same reasons, *Seneca Wire & Mfg. Co. v. A.B. Leach & Co.*, 247 N.Y. 1, 159 N.E. 700 (1928), also avails plaintiff nothing. In that case, plaintiff made it

*Section 16.4 of the Agreement expressly negatives the existence of any representations upon which the parties relied other than those set forth in the Agreement. (A. 61)

clear from the outset that he would buy only securities listed on the New York Stock Exchange. As the court stated in asking itslf whether the misrepresentations of defendant were material:

> "The parties themselves made the representations material, because Kinn told Bates that they only desired to purchase listed securities or those which were to be listed." (247 N.Y. at 6-7).

It should be noted also that in *Lauer* and *Seneca*, there was no question of the rights of third parties, inability to restore parties to the status quo, and delay in seeking rescission, all of which are present in the instant action so as to defeat rescission, even if we assume that the alleged breach was so fundamental as to otherwise warrant rescission. See Points II, III and IV, *infra*.

Furthermore, the Agreement expressly contemplated the possibility that a prompt registration might not be achieved, and thus further belies plaintiff's contention that registration was the essence of the Agreement. In case registration was not achieved, under Section 10.3 (App. 48), Darin was protected from a drop in the value of his shares to the extent of a commitment by CUM to deliver up to 77,323 additional Iota shares, depending on market conditions. This liquidated damage clause covering any delay in registration provided the agreed remedy for plaintiff on any claim of failure to use best efforts. At the very least, it certainly precludes claim of rescission of the entire Agreement for the

alleged failure to make adequate efforts to effect a prompt registration.

Similarly, the collateral nature of Iota's obligations as to registration is shown by the long holding period to which they applied. As stated in the Agreement, registration was to be maintained for nine months after the effective date, and a right was granted to a second registration in 1970 to remain in effect for another nine months (App. 58-60). At all times, Darin had the option whether or not to sell if registration became effective.

Finally, we would note that the Agreement sets forth more than four pages of conditions precedent to the exchange of stock in Sections 8 and 9 (App.43-47). This indicates further that the effectiveness of registration of the Iota stock was not of the essence of the Agreement since, if it had been, it would simply have been one of the many conditions precedent.

Accordingly, we submit that the benefit to Darin from Iota's promise to use best efforts to cause registration of his shares to become effective was clearly collateral to the basic exchange of shares, and any asserted deprival of Darin of that collateral benefit cannot provide a basis for rescission.

The cases cited by plaintiff (Br. 21, 25-6) relating to alleged breaches of "best efforts" obligations are of no help to plaintiff in this action since the District Court

assumed, for purposes of deciding defendants' motion to dismiss, that Iota had failed to comply with the "best efforts" requirement in this case (App. 198). Furthermore, none of the "best efforts" cases cited by plaintiff deal with the particular legal issues raised by this appeal regarding the extraordinary remedy of rescission.

Plaintiff makes repeated reference in his brief (Br. 20, 34) to Paragraph 13.7 of the Agreement (App. 57) which provides that Darin would be entitled to equitable relief for defendants' failure to comply with the covenants of the Agreement. Such boilerplate language cannot be said to justify the extraordinary remedy of rescission in this case. That paragraph makes no mention of plaintiff's right to rescission, and under what circumstances he would be entitled to exercise that right. To say that one is entitled to equitable relief for breach of contract is not to say that one is entitled to rescission regardless of the incidental nature of the breach, the rights of third parties, an inability to restore the st atus quo ante, and an unreasonable delay in the exercise of that right to the prejudice of other contracting parties.

POINT II

EVEN IF RESCISSION WHERE AN AVAILABLE REMEDY AGAINST IOTA AND CUM, THE COMPLAINT FAILS TO DEMONSTRATE ANY RIGHT OF PLAINTIFF TO THE ASSETS ONCE OWNED BY T. M. IN DISREGARD OF THE RIGHTS AND INTERESTS OF THIRD PARTIES TO WHOM THESE ASSETS HAVE BEEN TRANSFERRED.

Not only has plaintiff herein failed to demonstrate any right to rescission as against Iota or CUM, but plaintiff has failed to demonstrate in any way how the remedy of rescission is applicable as against the Hudson Bay defendants where the property sought to be recovered has been obtained by them as good faith purchasers and where no allegation has been made that the price paid by said defendants did not represent the fair value of the property purchased. It is respectfully submitted therefore that, assuming arguendo the remedy of rescission is available as against Iota and CUM, clearly no such remedy is available as against bona fide purchasers such as the Hudson Bay defendants. *Valentine v. Richardt*, 126 N.Y. 272, 27 N.E. 255 (1891); *E. W. Bliss Co. v. Progressive S & M Corp.*, 208 App. Div. 346, 203 N.Y.S. 320 (1st Dept. 1924); Debtor and Creditor Law, Section 278(1)(McKinney's 1945); *Hopfan v. Knauth*, 156 Misc. 545, 282 N.Y.S. 219 (Mun. Ct. of City of N.Y. 1935); Personal Property Law (McKinney's 1962), Section 40.

In *Valentine, supra*, an action to set aside a deed for fraud, the court ruled that plaintiff was not entitled to

obtain his original property since it had been conveyed to third parties who were bona fide purchasers for value. The court in *E. W. Bliss Co.* also upheld the rights of a third party purchaser for value.

The existence of these good faith purchasers of T. M.'s assets, and the assimilation of these assets into their businesses, makes it impossible, in any event, to restore the status quo ante. *Rudman v. Cowles Communications, Inc.*, 30 N.Y.2d 1, 280 N.E.2d 867 (1972).

Furthermore, the law is clear that the fact of notice by the plaintiff of a pending lawsuit involving the property at issue herein does not impair or otherwise destroy the standing of the Hudson Bay defendants as good faith purchasers. Cf. *Parker v. Conner*, 93 N.Y. 118 (1883); *Hall v. Bank of Blasdell*, 306 N.Y. 336, 118 N.E.2d 464 (1954); *Vidor v. Serlin*, 7 N.Y.2d 502, 166 N.E.2d 680 (1960); *Overseas Credit Corp. v. Cal-Tech Systems, Inc.*, 20 A.D.2d 355, 247 N.Y.S.2d 252 (1st Dept. 1964), *aff'd* 14 N.Y.2d 909, 200 N.E.2d 859 (1964).

A case relied upon by plaintiff, *Marr v. Tumulty*, 256 N.Y. 15, 175 N.E. 356 (1931), is not applicable to the case at bar. In that case, the third parties were not innocent purchasers for value because the same officers who were involved in the original fraud and bribery which resulted in the law suit also controlled the third party corporation.

Plaintiff's brief (26-27) gives a misleading impression of the court's holding in *Marr* and fails to state the key fact that the officers of the third party were themselves the perpetrators of the fraud.

Plaintiff alleges (¶15, App. 167) that on April 7, 1970 Darin demanded of CUC "that he have ownership of T. M. and its assets". No basis is shown in fact or in law for Darin's demand for not simply the stock but also the underlying assets of T. M. Even if rescission were available in this action, the transaction to be reversed would be the transfer of Darin's T. M. stock to CUM. T. M. is alleged (¶8, App. 165) to have owned on that date assets consisting of musical compositions, copyrights, licenses and contracts as well as the stock of several subsidiaries. A better view of the complexity of T. M.'s assets, liabilities, subsidiaries and commitments as of the closing may be gained by reading the covenants Darin gave with respect thereto in the sixteen subdivisions of Section 3 of the Agreement (App. 24-38) and by inferring therefrom what the omitted schedules to the Agreement must have shown as to such assets, liabilties, subsidiaries and commitments. Furthermore, these assets have since been disposed of to bona fide purchasers for value.

Plaintiff's prayer for relief (¶1, App. 170) does not specifically ask for a return of the stock of T. M., but instead demands all assets T. M. owned at closing as if they

had been liability free, which clearly was not the case. If on April 7, 1970 CUC had somehow caused CUM to return the T. M. stock, how could Darin thereby also gain a right of conveyance to him of that corporation's assets in disregard of its liabilities and the rights of creditors and other third parties?

Finessing this issue, the Complaint alleges (¶17, App. 168) that seven months after Darin's demand to receive personal ownership of the corporate assets of T. M., Iota caused some of those assets to be assigned "to one or more of" the three Hudson Bay defendants or three non-parties, Charles Koppelman, Donald Rubin and Koppelman-Rubin Enterprises. However, there is no allegation and no showing that such transfer was not made in good faith for fair value. Thus, no facts are alleged indicating the transfer to have been a fraudulent conveyance which could allow any creditor of T. M. (much less a sometime shareholder like Darin) to set it aside. Cf., *E.W. Bliss Co. v. Progressive S & M Corp., supra.*

The Complaint alleges that the Hudson Bay defendants at the time of the transfer had knowledge of Darin's earlier demand and of this litigation (¶18, App. 168-9). But absent facts showing that Darin actually had a right to the transferred assets, the transferees' awareness of his unorthodox assertion of personal ownership of corporate assets which had been sold one and a half years earlier

shows no liability on their part nor impropriety in the transfer. The Restatement of the Law of Restitution, cited by plaintiff (Br. 29), is not contrary to defendants' position since the Restatement requires the transferee to have notice of facts which give rise to a constructive trust on the property.

Accordingly, even if plaintiff were found to have pleaded a cause of action for rescission of the exchange of stock in 1968, he has failed to plead any right to any T. M. assets now owned by the Hudson Bay defendants.

POINT III

RESCISSION IS NOT AN AVAILABLE REMEDY SINCE IT IS IMPOSSIBLE TO RESTORE THE PARTIES TO THE STATUS QUO EXISTING AT THE TIME OF THE CLOSING OF THE AGREEMENT.

Restoration of the status quo ante is not possible in that the assets of T. M. were disposed of to bona fide purchasers, and events prior to the demand for rescission in 1970, as indicated in the Complaint, have radically changed the relative values of T. M. shares and the Iota shares which were exchanged in September, 1968. The courts have consistently held that rescission is not an available remedy unless the respective parties can be restored to their original positions. For better or for worse, T. M. is clearly not the company that it was when the Agreement was closed. In *Ungewitter v. Toch*, 31 A.D.2d 583, 294 N.Y.S.2d 1013 (3rd Dept. 1968), *aff'd* 26 N.Y.2d 687, 308 N.Y.S.2d 858 (1970), plaintiff sought to rescind the sale of a farm which he had bought from defendant some years earlier. The court refused to grant rescission, stating that the farm was not the same as it had been at the time of purchase, and that any attempt at restoring the parties to their original positions would be extremely difficult and involved. In *Slater v. Slater*, 208 App. Div. 567, 204 N.Y.S. 112 (1st Dept. 1924), *aff'd* 240 N.Y. 557, 148 N.E. 703 (1925), plaintiff sought to rescind a sale of stock to defendant, plus

an accounting and payment over of all dividends. Although plaintiff was willing to pay back the purchase price to defendant, there were other interests relating to the will of plaintiff's husband which defendant had surrendered at the time of the contract and which could not be restored to him. The court therefore denied rescission, and cited *Pullman v. Alley*, 53 N.Y. 637 (1873) for the following proposition:

> "The contract can only be rescinded where it is possible to put the parties back in their original position and with their original rights. 'A contract voidable for fraud cannot be avoided when the other party cannot be restored to his status quo: for a contract cannot be rescinded in part and stand good for the residue. If it cannot be rescinded in toto, it cannot be rescinded at all; but the party complaining of the nonperformance or the fraud, must resort to an action for damages.'" (204 N.Y.S. at 117)

See to the same effect *E.T.C. Corporation v. Title Guaranty & Trust Co.*, 271 N.Y. 124, 2 N.E.2d 284 (1936); *Schiffer v. Dietz*, 83 N.Y. 300 (1881); *Bedell v. Bedell*, 3 Hun. 580 (2d Dept. 1875); *Curtiss v. Howell*, 39 N.Y. 211 (1868).

From the Complaint, it appears that some T. M. assets have been transferred to the Hudson Bay defendants (¶¶17 and 19, App. 168, 169) and may have been re-transferred by them to other persons not before the Court (Prayer ¶1, App. 170). On T. M.'s assets, "rights, royalties and other profits" are alleged to have accrued since the closing.

But profits cannot have accured like money growing on trees. The complex music publishing business delineated in the Agreement could earn profits only through expenditure of time and effort to manage the company, including its numerous domestic and foreign subsidiaries (Agmt. §3.4, App. 25-7). Consider for example, Section 3.10(e)(App. 33), which reveals that certain "rights" of T. M. as a music publisher were subject to royalties to composers and lyricists, assignments of performance rights, undescribed agreements in Schedule H-8, mechanical reproduction licenses and synchronization licenses.

We submit that plaintiff is asking this Court to put Humpty Dumpty together again. The Complaint and annexed contract on which plaintiff sues reveal the impossibility of such task, and hence no cause of action for rescission has been pleaded.

Moreover, restoration of the status quo as of September 13, 1968 would not be achieved by plaintiff's proposed delivery of the 77,323 shares for apportionment by the Court among the defendants (Prayer ¶1, App. 170). The value of Darin's Iota stock on the commencement of this action had fallen from $18 a share to $.50 a share, that is, to about 3% of its value at the closing in 1968 (¶17, App. 165). Because of this huge drop in value, the return of Iota stock could not restore CUM and Iota to the position

they enjoyed on closing the Agreement. Hence, rescission is unavailable by reason of plaintiff's obvious inability to restore the parties to the status quo. *Tarleton Bldg. Corp. v. Spider Staging Sales Co.*, 26 A.D.2d 809 (1st Dept. 1966); *Holdeen v. Rinaldo*, 28 A.D.2d 947, 949 (3d Dept. 1967).

POINT IV

RESCISSION IS ALSO BARRED BY REASON OF PLAINTIFF DECEDENT'S DELAY IN SEEKING TO EXERCISE THIS REMEDY.

The right to rescission of a contract for breach must be exercised promptly to prevent any undue prejudice to other parties. The courts of this state have consistently denied plaintiffs the right of rescission where plaintiffs unduly delayed in the exercise of that right. In *Sarantides v. Williams, Belmont & Co., Inc.*, 180 N.Y.S. 741 (Sup. Ct. App. Term, 1st Dept. 1920), a case quite similar to the one at bar, the defendant sold stock to plaintiff and represented that the stock would be listed on the Exchange and that plaintiff would be guaranteed 7% dividends. Plaintiff took no action to rescind the agreement until six months after knowing that the stock was unlisted and dividends unreceived. The court denied his request for rescission, stating:

> "A party has a right to rescind a contract where he was induced to enter by fraud; but he must do so promptly, upon discovery of the fraud, and cannot speculate as to whether it would be more profitable to affirm his contract or rescind it." (180 N.Y.S. at 743)

In *Goldman v. Sontag*, 275 App. Div. 688, 15 N.Y.S. 2d 407 (3d Dept. 1939), the court reversed a judgment for rescission where plaintiff had failed to notify defendant immediately of his intention to rescind the contract.

Other New York cases affirming the same principle are: *Daitz Flying Corporation v. United States*, 167 F.2d 369 (2d Cir. 1948)(where defendant delayed from September 2 to January 26 before electing to rescind); *Trowbridge v. Oehmsen*, 207 App. Div. 740, 202 N.Y.S. 833 (2d Dept. 1924), *aff'd* 241 N.Y. 564, 150 N.E. 556 (1925); *Calhoun v. Millard*, 121 N.Y. 69, 24 N.E. 27 (1890); *Strong v. Strong*, 102 N.Y. 69, 5 N.E. 799 (1886); *Schiffer v. Dietz*, *supra*, 83 N.Y. 300; *Hallahan v. Webber*, 7 App. Div. 122, 40 N.Y.S. 103 (1st Dept. 1896); *Martin-Barris Co. v. Jackson*, 24 App. Div. 354, 48 N.Y.S. 586 (4th Dept. 1897). See also *United States Plywood Corp. v. Hudson Lumber Co.*, 113 F.Supp 529 (S.D.N.Y. 1953).

If the Complaint is read most liberally to allege that Darin would have sold his Iota shares before trading was suspended in the summer of 1969 if registration had become effective, and that registration was actually prevented by Iota's failure to use best efforts, any right of rescission based thereon would have accrued on or before the date of suspension of market trading (July 22, 1969), or of over-the-counter trading (August 1, 1969). Yet the Complaint shows (¶16, App. 167) that this action was not commenced until *over a year later*, that is, on August 27, 1970, by which time the stock of Iota had dropped from $18 a share to $.50 (¶17, App. 165). The Complaint further reveals

(¶15, App. 167) that Darin never even asked for rescission until April 7, 1970, over eight months after the suspension of trading.

Plaintiff in effect seeks nothing more than the freedom to speculate as to whether to affirm his contract or to rescind it, which the law does not permit. *Sarantides v. Williams, supra.*

By way of excuse, plaintiff alleges (¶12, App. 166-7) that "commencing in the early spring of 1969" one Charles Koppelman gave Darin "repeated assurance" that "registration would soon become effective and that, if it did not, plaintiff could recover ownership and control of T. M. and its assets". A prediction that registration would soon become effective, if made, was consonant with the filing of the amendments on April 29 and June 27. But nothing shows any justification for Darin seeking or relying on advice as to his rights under the Agreement from Koppelman, who is identified only as "an officer of CUM and/or a director of CUC" (¶12, App. 167).

In any event, plaintiff makes no claim of reliance on representations by Koppelman or anyone else after the spring of 1969. Since it is admitted that the Commission suspended all trading on August 1, 1969, there were no apparent grounds thereafter for him to believe registration would become effective or to delay his rescission demand until April 7, 1970.

Accordingly, we submit that the Complaint on its face shows rescission to be barred by Darin's unexcused delay in seeking rescission until after a prejudicial drop in the value of his Iota shares.

POINT V

THE COMPLAINT IS FATALLY DEFECTIVE IN THAT IT LACKS ANY ALLEGATIONS SHOWING THAT IOTA'S ALLEGED FAILURE TO USE ITS BEST EFFORTS TO REGISTER DARIN'S STOCK CAUSED ANY INJURY TO DARIN.

The Complaint does not allege what action, if any, the SEC took with respect to the registration statement Iota filed November 27, 1968 or as to either of the amendments thereto. It is not even alleged that the registration never became effective. If that be inferred, there still is no allegation that the alleged failure of Iota to use best efforts was the cause.

Nowhere does the Complaint allege that if the facts as to Kleiner Bell and Perfect Film which plaintiff says were omitted in the amendment filed April 29, 1969 had been included, the Commission would have made the registration statement effective. Neither does the Complaint allege that under applicable statutes, rules and regulations of the SEC such omissions were material, or made the registration statement clearly or even possibly defective, let alone that Iota and its "New York corporate counsel" knew or had reason to be aware of such deficiency, or willfully omitted such facts or sought to frustrate registration of Darin's shares.

The Complaint refers gratuitously (¶10, App. 166) to a different registration statement filed by Iota on February

3, 1969 to implement an exchange offer for shares of Warner Bros.-Seven Arts Limited. It also refers (¶13, App. 167) to an Iota proxy statement of June 24, 1969 which sought authorization of Iota's acquisition of the Rexall operation of Dart Industries. Nothing appears, however, to show how such collateral filings relate to the basic charge of failure to use best efforts to register Darin's shares.

The Complaint further alleges (¶17, App. 164-5) the July 22, 1969 suspension by the American Stock Exchange of trading in Iota shares, the Commission's suspension of over-the-counter trading from August 1 to December 23, 1969 and the precipituos drop in market value of Iota shares from $18 in 1968 to $.50 in 1970. Thus, even without drawing upon the District Court's knowledge of the calamities which befell Iota in the summer of 1969 after the abortive Warner Bros. and Rexall deals, the Complaint compels the question: Could Iota's inclusion of facts as to Kleiner Bell and Perfect Film in the April 29, 1969 amendment, or indeed any further efforts whatever by Iota, possibly have resulted in the registration of Darin's shares? No allegation of facts, indeed not even a conclusory allegation, shows that the answer to this core question would be affirmative.

Dismissal is compelled by plaintiff's failure to plead any causal connection between Iota's alleged failure to

use best efforts and any consequent effect upon the action taken by the Commission as to the registration statement. A sufficient causal connection between an alleged breach and actual injury must be pleaded. *Stern v. Andrew*, 249 App. Div. 171 (1st Dept. 1936).

Moreover, even if there were factual allegations in the Complaint that the registration statement covering Darin's shares would have become effective but for the claimed deficiencies in the amendment of April 29, 1969, it still does not follow that Darin was injured in consequence. Conspicuously, there is no allegation that Darin intended to sell or would have sold his Iota shares when registration thereof became effective, or what the price would have been upon the sale of such a sizable block of shares.

Further, the text of the Agreement clearly demonstrates that Darin would not automatically have sold his shares upon registration. Under Section 14 (App. 58-60), the effectiveness of the registration statement was to be maintained for a full nine months. Thereafter, in the same section, Darin is granted the right to have his shares included in any further registration statement filed by Iota during 1970. Such 1970 registration was also to be maintained for another nine months. Thus, the Agreement shows the parties contemplated that Darin might retain his shares long after the effective date of the anticipated registration under the initial 1968 filing. Hence, no inference can

be made that Darin would have sold his stock upon effectiveness of registration based on either the filing of April 29, 1969 or that of June 27, 1969.

Finally, the Complaint does not contain any allegation that lack of registration prevented the sale of Darin's shares. Under the rules of the Commission, unregistered shares may be sold to a purchaser accepting the shares as unregistered. Moreover, before his death in December, 1973, Darin had long since completed the holding period under SEC Rule 144, promulgated in January, 1972 (17 C.F.R. 230.144), making registration no longer a prerequisite for sale after a two-year holding period. Even under the old "change of circumstances" rule, the collapse of Iota should have given him a basis to obtain a no-action letter from the Commission permitting a sale. Thus, if plaintiff still holds Darin's 77,323 shares, it is not because of any lack of registration but a voluntary decision following the precipitous drop in value of Iota's stock (¶7, App. 165) due to factors not alleged to have been caused by Iota's purported breach of its best efforts commitment to Darin. As it was stated in *Hoshman v. Esso Standard Oil Co.*, 263 F.2d 499, 502 (5th Cir. 1959):

> "...when the facts, alleged or assumed within the frame work of the complaint, show that the claim is without merit there is no need to go to trial."

See also *Brooks v. United States*, 152 F.Supp. 535

(S.D.N.Y. 1957).

Accordingly, dismissal should be granted. Plaintiff has failed to plead facts showing that the alleged breach caused the SEC to withhold registration and that any lack of such registration actually prevented a sale of shares Darin would have made. Absent these essential allegations, the asserted failure to perform the best efforts obligation is *damnum absque injuria* and cannot support a claim for rescission.

POINT VI

RESCISSION IS NOT AN AVAILABLE REMEDY AGAINST CUM SINCE THE COMPLAINT ALLEGES NO BREACH OF CONTRACT ON THE PART OF CUM

The Complaint tries to ignore the fact that the T. M. shares were transferred to CUM pursuant to Paragraphs 1 and 10.2 of the Agreement (App. 23, 47). Since the Complaint does not charge any breach of contract on the part of CUM, plaintiff has failed to state any cause of action against that corporation, much less a cause of action for rescission. There are no allegations, nor valid legal grounds, for permitting plaintiff to acquire the stock or assets of one corporation because of an alleged breach by another. Although CUM is a subsidiary of Iota, it is a separate legal entity. Thus, even assuming that CUM still has any T. M. assets in its possession, the Complaint shows no valid ground for applying the remedy of rescission to this defendant. See in this regard *Royal Industries v. St. Regis Paper Co.*, 420 F.2d 449 (9th Cir. 1969), a patent infringement suit in which the court refused to disregard the existence of separate legal entities, although one was the wholly owned subsidiary of the other. In *Rudman v. Cowles Communications, Inc.*, *supra*, 30 N.Y. 2d 1, a suit for rescission of an employment contract, plaintiffs' assets were conveyed by Cowles to one of its subsidiaries. The court ruled that rescission was unavailable because it was impracticable to restore the status quo, since

the assimilation of plaintiffs' assets into another legal entity had already taken place.

POINT VII

THE DISTRICT COURT'S ORDER STRIKING PORTIONS OF THE AMENDED UNIFIED COMPLAINT WAS A PROPER EXERCISE OF DISCRETION AND, IN ANY EVENT, DID NOT PREJUDICE THE RIGHTS OF PLAINTIFF.

The July 11, 1975 order of the District Court (App. 155-60) struck from the Amended Unified Complaint four allegations and an exhibit which made reference to an SEC injunction action against Iota. The allegations were impertinent and immaterial within the meaning of Rule 12(f) of the Federal Rules of Civil Procedure. Similar allegations referring to the same SEC injunction action against Iota were previously stricken from the complaints in the *Fried* and *Teitelbaum* actions in this Docket.

In Section 14 of the Agreement (App. 60), Iota promised that "during 1968" it would file a registration statement covering Darin's shares. The Unified Complaint (¶9, App. 75) acknowledges that on November 27, 1968, a registration statement was filed with the Commission covering the Darin shares. This was clearly a timely filing, and there is no claim of any deficiency in the registration statement as filed.

Notably, there is no allegation by plaintiff that the Commission's complaint against Iota referred in any way to the November 27, 1968 registration statement or its amendments of April 29, 1969 and June 27, 1969 regarding

Darin's shares. Rather, the Commission's complaint attacked *two different filings* by Iota: a registration statement filed February 3, 1969 for the registration of stock for use in a proposed merger with Warner Bros.-Seven Arts Limited, and a proxy statement dated June 24, 1969.

In an apparent attempt to tie the April 29, 1969 Amendment to the Commission's action, plaintiff alleged (¶11, App. 76-7) that such Amendment

> "was subject to objection by the Commission on grounds noted in its aforesaid complaint with respect to the February 3, 1969 registration statement, in that said Amendment, inter alia, (i) omitted to state material facts as specified in paragraphs 8(b)(2), 8(b)(3), 8(c)(2), 8(d)(3) of Exhibit C (SEC Complaint)."

Plaintiff then similarly alleged (¶14, App. 78) that the June 27, 1969 Amendment to the registration statement was objectionable by reason of the Commission's attack on the June 24, 1969 proxy statement:

> "Said Amendment was subject to objection by the Commission on grounds noted in its aforesaid complaint with respect to the proxy statement mailed by CUC on June 24, 1969 to its stockholders in that said Amendment, inter alia, omitted to state material facts and failed to disclose fully and accurately material facts as specified in paragraphs 11(a)-(d) of Exhibit C."

Although plaintiff made the Commission's complaint Exhibit C to the Amended Unified Complaint, he did not attach or refer to the Judgment for Permanent Injunction and the Consent thereto upon which the action was terminated. Both

documents, copies of which were annexed to defendants' Notice of Motion below (App. 107-110) were filed in the United States District Court for the District of Columbia on October 2, 1969, the same date that the Commission's complaint was filed. The consent judgment recites that Iota "entered a general appearance without admitting the allegtions of the complaint...and consented to the entry of a permanent injunction" while the accompanying Consent repeats that it is given "without admitting the allegations of the complaint". Plaintiff's failure to refer to these documents only increased the prejudicial impact of the pleading of the Commission's complaint.

Much of the law in this area has been developed in private antitrust suits in which the plaintiff seeks to take advantage of a prior judgment procured by the Government as permitted by §5 of the Clayton Act, 15 U.S.C. §16(a). That section permits a private action in reliance only on a judgment obtained by the Government *on the merits*, and prohibits proof of violations by consent judgment. This provision substantially embodies the common law. The securities acts on which plaintiff apparently relies in attempting to show a breach of the Agreement have no provisions analogous to this special feature of the antitrust laws. Hence, the common law rule is applicable and, thereunder, plaintiff could not offer proof of the Commission's action and its

resulting consent judgment. *Buckeye Power Co. v. E.I. Du Pont De Nemours Power Co.*, 248 U.S. 55, 63 (1918). As stated in *International Shoe Machinery Corp. v. United Shoe Machinery Corp.*, 315 F.2d 449, 459 (1st Cir. 1963), *cert. denied* 375 U.S. 820 (1963):

> "Moreover, it is clear that if common law rules of admissibility were applied, the plaintiff would be unable to derive evidentiary benefit from the prior Government judgment. (citation) Until the advent of Section 5 (of the Clayton Act), these judgments were unavailable to a private plaintiff."

Further, since no issues of fact or law were determined in the Commission's action, the consent judgment can have no collateral estoppel effect. *United States v. International Building Co.*, 345 U.S. 502 (1952).

Since plaintiff may not derive evidentiary benefit from the consent judgment, he certainly should not derive equivalent benefit from the bare allegations of the Commission's complaint on which it was founded. To prevail in this action, plaintiff must establish a breach of the Agreement by independent evidence; if a violation of the securities laws becomes relevant to show a breach, then the acts or omissions constituting such violation must be alleged and proven without reference to the Commission's action. As explained in *International Shoe*, *supra*, in the context of a private antitrust action:

> "If he does not have the independent evidence, we do not believe that he should be able to use the prior judgment as a crutch in the attempt to supply the essential elements of his action. It would be subversive of the purpose of Section 5 to permit the introduction of a prior decree or judgment 'merely for its aura of guilt, or to imply new wrongdoing from past wrongdoing'." (315 F.2d at 459-60)

Since evidence of the prior SEC action would not be admissible at trial, the allegations referring thereto are clearly immaterial and impertinent within the meaning of Rule 12(f) of the Federal Rules of Civil Procedure. *Parks-Cramer Co. v. Mathews Cotton Mills*, 36 F.Supp. 236, 238 (W.D.S.C. 1940). See also: *Atlantic City Electric Co. v. General Electric Co.*, 207 F.Supp. 620, 629 (S.D.N.Y. 1962); *Alden-Rochelle, Inc. v. American Society of Composers, Authors and Publishers*, 3 F.R.D. 157, 159 (S.D.N.Y. 1942).

Furthermore, since the SEC complaint makes no objection to the separate registration statement covering Darin's shares or to either of the amendments thereto, the prejudicial effect of these irrelevant allegations is even more striking.

Allegations related to the filing of April 29, 1969 of Darin's stock is likewise impermissible where it refers to an SEC complaint against Iota. Such evidence is incompetent to prove the allegations of the complaint, and prejudicial to the defendants' case, regardless of whether the filings related to Darin's stock or that of other Iota shareholders.

It should be noted here that plaintiff's statement (Br. 8-9, 36, 41-2) of the District Court's order striking the four allegations is misleading. The Court did not prevent plaintiff from *pleading any deficiencies* in the Iota filings regarding Darin's shares, but rather prevented plaintiff from *pleading the opinion of the SEC* regarding those filings. [Compare paragraphs 11, 13 and 14 of the Amended Unified Complaint (App. 76-8) with the same numbered paragraphs of the Second Amended Unified Complaint (App. 166-7)]. Naturally, any pleading of deficiencies in Iota filings regarding shares other than Darin's is immaterial and impertinent within the meaning of Rule 12(f).

Finally, an important point to remember is that plaintiff has not been prejudiced by the court's order striking the extraneous allegations. For purposes of defendants' motion to dismiss, the District Court was required to assume the truth of plaintiff's allegation that Iota failed to use "best efforts" (App. 198). Thus, plaintiff's allegations regarding the SEC and other filings could give him no greater advantage in terms of the motion to dismiss. Plaintiff has thus failed to show how the court's order in this regard prejudiced his rights.

CONCLUSION

THE DISTRICT COURT'S ORDER AND JUDGMENT DISMISSING THE SECOND AMENDED UNIFIED COMPLAINT WITH PREJUDICE AND STRIKING CERTAIN MATERIAL FROM THE AMENDED UNIFIED COMPLAINT SHOULD BE AFFIRMED, WITH COSTS.

Respectfully submitted,

BURNS, VAN KIRK, GREENE & KAFER
Attorneys for Defendants-Appellees Iota Industries, Inc. and Commonwealth United Music, Inc.
521 Fifth Avenue
New York, New York 10017
Telephone: (212) 972-0500

WILLIAM D. GREENE
JAMES P. CORCORAN
Of Counsel

SERVICE OF 2 COPIES OF THE WITHIN

Appellees Brief

IS HEREBY ADMITTED.

DATED: JUL 2 1976

Lord, Day & Lord

Attorneys for Defendants Hudson Bay Music Company, Alley Music Corporation and Street Sounds, Inc.

SERVICE OF 2 COPIES OF THE WITHIN

Appellees Brief

IS HEREBY ADMITTED.

DATED: July 2, 1976

Patterson, Belknap & Webb, by White Burns

Attorneys for Appellant